

Sanitized Copy Approved for Release 2010/01/25 : CIA-RDP85T01058R000405170001-9

filed  
cy.

DATE 11/5/85

DOC NO 61M85-10246

OCR CYS 3

P&PD CY 1

State Dept. review  
completed

Sanitized Copy Approved for Release 2010/01/25 : CIA-RDP85T01058R000405170001-9

Central Intelligence Agency



51

Washington, D.C. 20505

## DIRECTORATE OF INTELLIGENCE

23 SEP 1985

MEMORANDUM FOR: Lauralee Peters, Director  
Office of Monetary Affairs  
Department of State

FROM: [redacted]

25X1

Acting Chief  
Economics Division  
Office of Global Issues

SUBJECT: Current Assessment of LDC Debt Problems

Attached is an advanced copy of an assessment done by our Financial Issues Branch entitled The Current LDC Debt Situation: Rising Frustrations. The paper looks at LDC debtor reactions to the current economic environment of limited trade growth and reduced credit availability. It also discusses ideas currently being put forward for alternative strategies to the debt problem. We hope you will find it useful especially in preparation for the Seoul IMG/IBRD Meetings. If you have any comments or questions feel free to call [redacted]

25X1

25X1

25X1

## Attachment:

The Current LDC Debt Situation: Rising Frustrations, [redacted] GI M 85-10246 [redacted]

25X1

25X1

25X1

Central Intelligence Agency



Washington, D.C. 20505

## DIRECTORATE OF INTELLIGENCE

23 SEP 1985

MEMORANDUM FOR: Edwin Truman, Director  
Division of International Finance  
Federal Reserve Board of Governors

FROM: [REDACTED] 25X1  
Acting Chief  
Economics Division  
Office of Global Issues

SUBJECT: Current Assessment of LDC Debt Problems

Attached is an advanced copy of an assessment done by our Financial Issues Branch entitled The Current LDC Debt Situation: Rising Frustrations. The paper looks at LDC debtor reactions to the current economic environment of limited trade growth and reduced credit availability. It also discusses ideas currently being put forward for alternative strategies to the debt problem. We hope you will find it useful especially in preparation for the Seoul IMG/IBRD Meetings. If you have any comments or questions feel free to call [REDACTED]

25X1

25X1

25X1

Attachment:  
The Current LDC Debt Situation: Rising Frustrations, [REDACTED] GI M 85-10246 [REDACTED]

25X1

25X1

25X1

Central Intelligence Agency



Washington, D.C. 20505

## DIRECTORATE OF INTELLIGENCE

23 SEP 1985

MEMORANDUM FOR: David Wigg  
Senior Director for International Economic  
Affairs  
National Security Council

FROM: [redacted]

25X1

Acting Chief  
Economics Division  
Office of Global Issues

SUBJECT: Current Assessment of LDC Debt Problems

Attached is an advanced copy of an assessment done by our Financial Issues Branch entitled The Current LDC Debt Situation: Rising Frustrations. The paper looks at LDC debtor reactions to the current economic environment of limited trade growth and reduced credit availability. It also discusses ideas currently being put forward for alternative strategies to the debt problem. We hope you will find it useful especially in preparation for the Seoul IMG/IBRD Meetings. If you have any comments or questions feel free to call [redacted]

25X1

25X1

25X1

## Attachment:

The Current LDC Debt Situation: Rising Frustrations, [redacted] GI M 85-10246 [redacted]

25X1

25X1

25X1

**THE CURRENT LDC DEBT SITUATION:**

**RISING FRUSTRATIONS**

25X1

**An Intelligence Assessment**

Information available as of 16 September was used in this report.

This paper was prepared by [redacted]  
Office of Global Issues. Comments and queries are welcome and  
may be directed to the Chief, Financial Issues Branch, OGI, on  
[redacted]

25X1

25X1

25X1

## Contents

### Page

#### Key Judgments

LDC Needs for External Funds Increase  
Current Account Positions Deteriorating  
Reserves Being Drawn Down  
Development Process Stagnating

#### Tightening Supply of Credit

Increasing Politicization of the Debt Issue  
Cartagena Moves to Centerstage  
Other Calls for Action

#### Outlook

Needed LDC Action  
Financial Community Response  
LDC Political Initiatives

## The Current LDC Debt Situation: Rising Frustrations

25X1

## Key Judgments

Debt-troubled LDCs' dissatisfaction with their chronic financial problems is growing. Their inability to convince creditor nations that restoring solvency by complying with IMF-supported austerity programs is politically risky is heightening debtors' frustrations. The perception among governments and voters alike in these countries is that their financial obligations have become overwhelmingly burdensome, that living standards have suffered enough, and that multiyear debt reschedulings only postpone, rather than ease, the repayments burden. Thus, LDCs will continue to press industrial governments to share the costs they believe are required to make their external finances manageable.

With little significant economic improvement foreseen in the coming months, mounting political pressure and economic troubles have led the 11 Latin American nations of the Cartagena Group to examine proposals for interest payment relief. Already, Peru has chosen to limit its debt payments to a small percentage of export earnings. Most debt-troubled countries--even those that have been the voices for moderation during the past three years--are advocating increased funding for the multilateral financial institutions such as the IMF and World Bank and greater financial participation by industrial governments.

Meanwhile, significant changes in the global economy are adversely affecting the availability of funds to LDCs. Countries that had been major net suppliers of funds such as the United

25X1

States and Saudi Arabia are becoming net users. The financing of industrial country and OPEC current account deficits has become a significant factor influencing the availability and cost of funds for LDC borrowers through the decade. The reluctance of Western banks to increase their loan exposure to many LDCs is another contributing factor. Consequently, we do not expect the resumption of spontaneous bank lending to many debt-troubled LDCs until their overall debt levels are substantially reduced, which is unlikely to occur in this decade.

We believe the challenge currently facing the international financial community is to find a "carrot" that can be used to reward debt-troubled LDCs that undertake substantial structural economic reforms. At present, the adjustments made are of a short-term nature--devaluations, and cuts in subsidies and wages--while the fundamental inefficiencies and rigidities of the debtor's economy go unaddressed. For example, LDCs must reduce government involvement in business and industry, strengthen private-sector enterprise, and increase incentives for private and foreign investment.

Many financial observers suggest that the World Bank's lending must be expanded to help boost growth and development in debt-troubled countries. Although continuing their efforts in project financing, World Bank officials are pursuing a more catalytic role for the Bank, including cofinancing with commercial banks, aid coordination, collaboration with export credit agencies, and encouragement of direct private investment. The initiatives, however, are somewhat constrained

by the Bank's limited resource base. Meanwhile, the International Monetary Fund (IMF) remains the focal point for short-term financial assistance. We believe, however, the Fund will resist expansion of its responsibilities through enhanced surveillance programs, which creditor governments and commercial banks have encouraged, because it does not want to be viewed as the "policeman" of the international financial community.

In our judgment, the debtors will use every available forum to push for financial relief by demanding that industrial countries:

- o Implement sound economic policies to promote world growth and lower real interest rates.
- o Resist protectionist tendencies and thereby provide open markets for LDC exports.
- o Boost multilateral development resources, particularly from the World Bank and Inter-American Development Bank, to increase development lending.
- o Reform some European regulatory environments, which currently restrict commercial bank lending to LDCs.

Their requests could come to a head this fall. For the first time, the LDCs have submitted proposed reforms--including easing conditionality of creditor lending and increasing international liquidity--for consideration at the upcoming IMF/World Bank annual meetings in Seoul. Moreover, the economic and foreign ministers of the Cartagena Group of 11 Latin debtors



plan to meet soon. Given the current environment, we cannot rule out more radical demands or actions by debt-troubled countries such as making only partial interest payments to commercial banks. In this regard, the Mexican Government bears the closest watching; its political and financial troubles could lead that country to be the first of the big three debtors--Brazil, Mexico, and Argentina--to confront creditors with alternate solutions to the LDC debt problem.

25X125X1

The Current LDC Debt Situation: Rising Frustrations [ ] 25X1

LDC Needs for External Funds Increase

The LDCs made marked improvements in their current account positions in 1984 and began to rebuild their reserves. Now, however, the current account performance of the key LDCs is deteriorating and some countries are drawing down their reserves. Many debt-troubled LDCs need to obtain new loans to make interest payments, bolster reserves, make principal repayments, and develop their economies. [ ] 25X1

Current Account Positions Deteriorating

The positive adjustments in LDC current account balances that occurred in response to the debt crisis were surprisingly dramatic (table 1). According to International Monetary Fund (IMF) estimates, the aggregate current account deficit of nonoil LDCs was cut by two-thirds--from \$113 billion in 1981 to \$38 billion in 1984. The most impressive gains were made by Brazil and Mexico. [ ] 25X1

Much of this improvement resulted from two overlapping conditions--the new era of extreme financial constraints and the shift from global recession to global recovery. Specifically:

- o With the emergence of the debt crisis in 1982, voluntary lending, other than for short-term trade finance, became virtually unobtainable for many LDCs. This situation proved particularly painful for active market borrowers, such as Brazil and Mexico. The sharp adjustments, due to reduced credit, required by these borrowers was reflected in their import levels, which showed a steep

Sanitized Copy Approved for Release 2010/01/25 : CIA-RDP85T01058R000405170001-9

	1981			1982			1983			1984			1985		
	Exports	Imports	Current Account												
<b>TOTAL</b>	191.1	203.4	-56.0	178.4	181.0	-60.6	179.7	162.2	-26.1	200.1	163.0	-7.5	190.4	162.7	-13.1
Brazil	23.3	24.1	-11.7	20.2	21.1	-16.3	21.9	16.8	-6.8	27.0	15.2	-0.1	25.5	13.5	-2.0
Mexico	19.6	24.1	-13.9	21.2	15.1	-5.7	21.8	8.0	5.2	24.4	11.3	4.0	22.2	15.0	-0.8
South Korea	21.2	26.1	-4.6	21.8	24.2	-2.6	24.4	26.2	-1.6	29.2	30.6	-1.4	29.5	30.0	-1.3
Argentina	9.1	9.4	-4.7	7.6	5.3	-2.3	7.8	4.5	-2.4	8.1	4.6	-2.5	7.7	4.6	-2.0
Indonesia	22.3	13.3	-0.6	22.3	16.9	-5.3	21.1	16.3	-6.3	21.9	13.9	-2.1	20.5	14.7	-1.8
Venezuela	20.2	12.1	4.0	16.5	12.6	-4.2	14.8	6.4	4.4	15.9	7.9	5.0	13.4	7.2	2.5
Philippines	5.7	7.9	-2.1	5.0	7.7	-3.2	5.0	7.5	-2.7	5.4	6.1	-1.2	4.8	5.5	-1.0
Egypt	3.2	8.8	-2.1	3.1	9.1	-2.2	3.2	10.3	-0.8	3.6	10.3	-0.9	3.6	10.4	1.3
India	8.7	15.5	-3.2	9.4	15.2	-3.0	9.6	15.3	-2.8	9.3	14.0	-2.1	8.8	13.3	-2.2
Nigeria	17.9	18.9	-5.8	12.1	14.8	-7.2	10.5	11.4	-4.2	11.9	8.9	0.5	10.5	9.0	0.1
Chile	3.9	6.4	-4.7	3.7	3.5	-2.3	3.8	3.0	-1.1	3.7	3.2	-2.1	3.8	3.3	-1.8
Malaysia	11.7	11.8	-2.5	11.9	12.7	-3.5	13.8	13.2	-3.1	16.1	14.3	-2.2	16.3	14.0	-1.9
Algeria	14.1	11.3	0.1	13.5	10.7	-0.2	12.7	10.4	-0.1	12.8	10.3	-0.1	13.4	10.6	0.0
Thailand	6.9	9.9	-2.5	6.8	8.4	-1.0	6.3	10.2	-2.9	7.3	10.3	-2.1	7.3	9.5	-1.8
Peru	3.3	3.8	-1.7	3.3	3.7	-1.6	3.0	2.7	-0.9	3.1	2.1	-0.2	3.1	2.1	-0.4

*Projected*

Sources: International Financial Statistics and CIA estimates.

25X1

Table 2

## Reserve Positions of the Key Debtors

	Yearend 1983	Yearend 1984	End of June 1985	Billion US \$ Percent Change, 1984/85
Brazil	4.2	11.7	11.4	-2.6
Mexico	3.7	7.4	4.5	-39.2
South Korea	6.9	7.6	6.6	-13.2
Argentina	1.1	1.3	1.2 <sup>a</sup>	-7.7
Indonesia	3.5	4.9	4.9	0.0
Venezuela	7.3	9.1	9.9	8.8
Philippines	0.7	0.6	0.7	16.7
Egypt	0.7	0.7	0.9 <sup>b</sup>	28.6
India	4.7	6.0	6.2 <sup>c</sup>	3.3
Nigeria	0.9	1.5	1.2	-20.0
Chile	1.9	2.3	1.7	-26.1
Malaysia	3.6	3.8	4.0	5.3
Algeria	1.8	1.5	2.5	66.7
Thailand	1.6	1.9	2.1	10.5
Peru	1.3	1.6	1.5 <sup>d</sup>	-6.2

<sup>a</sup>End of May figure.<sup>b</sup>End of April figure.<sup>c</sup>End of March figure.<sup>d</sup>End of January figure.Source: International Financial Statistics and CIA estimates.

25X1

decline starting in 1982.

- o The improvement in the international economy--notably rapid US-led OECD economic growth and lower interest rates--that began in late 1983 also helped the current account performance of many debt-troubled LDCs, allowing them to expand exports and reduce interest payments during 1984.

25X1

This year, however, LDC current account performance is again deteriorating. Some LDCs such as Mexico and Indonesia have increased imports to foster economic growth and bolster living standards at a time when moderating OECD growth is slowing LDC exports; we expect the exports of the key LDCs to decline by \$10 billion this year--after a \$20 billion surge in 1984. Mexico has moved from a sizable current account surplus in 1983 and 1984 into an expected deficit of almost \$1 billion in 1985. Brazil and Venezuela are also experiencing a significant worsening in their current account positions.

25X1

#### Reserves Being Drawn Down

After registering a \$6.4 billion buildup in 1983 and a \$13 billion increase in 1984, the reserves held by the nonoil LDCs have begun to decline according to financial reporting. The reserves of the nonoil LDCs as a group rose by 15 percent in 1984, the largest increase since 1980. The most dramatic gains were made by the Latin American countries, which increased their reserves by 56 percent to \$32 billion.

25X1

Many financial observers suggest that the World Bank's lending must be expanded to help boost growth and development in

countries that are forced to finance their growing current account deficits with little access to new credits (table 2). As a larger percentage of reserves is used for current account financing, LDCs will find it increasingly difficult to maintain their current level of imports. We believe import coverage ratios, which had improved dramatically through 1984, are now unlikely to be sustained.<sup>1</sup> [redacted]

25X1

#### Development Process Stagnating

For many of the countries experiencing debt-servicing troubles, economic growth slowed during the first half of the 1980s. Despite the recent recovery of industrial economies and LDC adjustments, the debt-troubled countries have neither returned to the robust growth rates of the 1960s nor significantly boosted economic development. According to the World Bank, the average per capita incomes of many African and Latin American countries are the same in real terms as they were in the 1970s, and LDC economic growth over the last five years is only one-half the rate achieved in the 1970s. [redacted]

25X1

LDC exports in 1980-85 have grown close to 6 percent a year, but due to interest payments, import growth has been little more than 1 percent a year. As export earnings are increasingly used to make interest payments, LDCs have fewer resources available to fund development projects. The World Bank estimates that the financial strains of the past few years have caused many LDCs to

<sup>1</sup>Because reserves are used primarily to make interest payments or finance imports, the financial community uses import coverage ratios to determine how many months of imports can be funded by reserves--at least three months of coverage is desirable. [redacted]

25X1

lose at least a decade of development. [redacted]

25X1

### Tightening Supply of Credit

Significant changes in the global economy are adversely affecting LDC access to new money. An important shift occurred in the past several years as countries that had been major suppliers became net users of funds. OPEC's huge infusion of investable funds during 1974-84 ended as world oil markets softened and the countries like Saudi Arabia slid into deficit. The aggregate current account position of industrial countries also deteriorated, although this trend masks large disparities within the group; the United States has the largest deficit while Japan is running a huge surplus. The financing of industrial country and OPEC current account balances is significantly influencing the availability and cost of funds for the generally riskier LDC borrowers through the decade. [redacted]

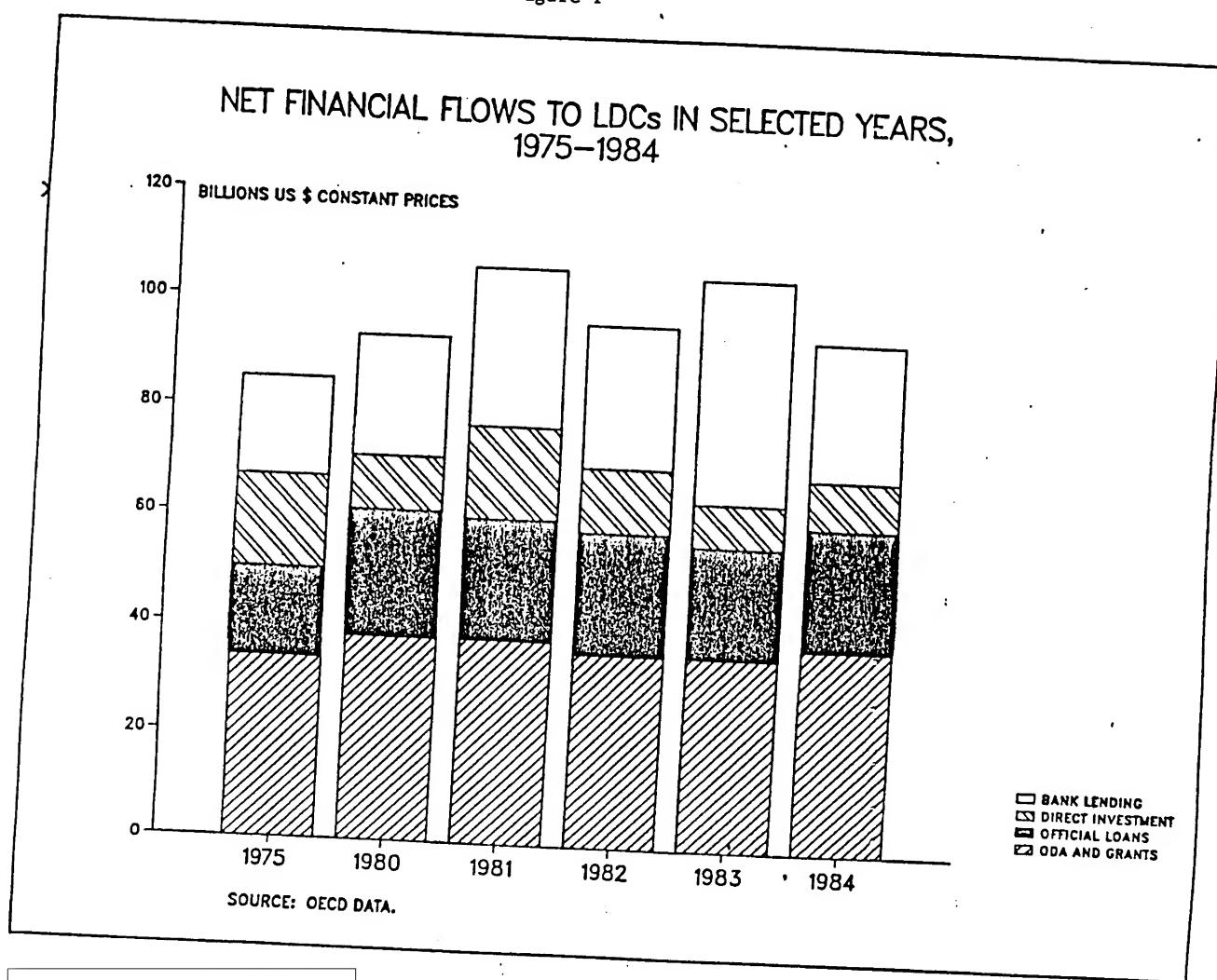
25X1

Another factor contributing to the tightening supply of credit has been the decline in long-term bank lending--down from \$41 billion in 1983 to \$25 billion in 1984. In addition, according to OECD data, short-term bank lending to LDCs fell \$5 billion last year. Commercial banks remain reluctant to lend to debt-troubled LDCs until they are better able to service their interest and principal payments. [redacted]

25X1

At the same time, other sources of financing--official transfers and credits and direct investment--have been relatively stable (see figure 1). In our view, these sources of funds remain unlikely to grow for most debt-troubled LDCs because:

Figure 1



- o The bulk of Official Development Assistance will continue to be directed toward poorer countries that do not depend heavily on Western bank financing.
- o Other official flows such as official export credits and multilateral institution lending are not likely to rise much, given budgeting constraints in both industrial countries and OPEC.
- o Foreign direct investment is not likely to increase significantly during the second half of the decade, primarily in light of economic problems in many LDCs.
- o LDC bond financing is only a minor source of funds, and investors will continue to be reluctant to purchase these bonds in view of poor LDC creditworthiness.

[ ]  
25X1

#### Increasing Politicization of the Debt Issue

The LDC financial situation remains serious, and political frustrations are more and more evident. Balance-of-payments troubles, a lack of a dialogue on debt with creditor governments, and IMF compliance difficulties are heightening debt-troubled countries' disgruntlement. Many governments--especially in Latin America--are under increasing political pressure to obtain new financial agreements with creditors to ease their foreign debt burden and to boost economic growth. For example:

- o President Sarney of Brazil is reluctant to make additional cuts in government spending because of

intensive domestic political pressure to continue the economic recovery.

- o President de la Madrid of Mexico is facing increasing pressure from the public against new government cutbacks and for finding an alternative to Mexico's present debt arrangements.
- o President Lucinshi of Venezuela is under strong pressure from the political opposition and labor groups to abandon the multiyear rescheduling agreements.
- o President Garcia of Peru has refused to negotiate with the Fund because he fears the potential economic and social consequences.

In response to these pressures, Latin leaders have publicly stated that their external debt problem is far from being solved and that it continues to be an obstacle to economic development and to the strengthening of their political democracies. They believe that multiyear debt reschedulings only postpone repayments and do not provide a long-term solution to their problem. Thus, these leaders support a two-track approach to resolving their financial burden: servicing their debt to the best of their ability, while concurrently seeking more concessions.

#### Cartagena Moves to Center Stage

Latin American countries have occasionally met among themselves during the last three years to discuss their debt troubles and alternative solutions. The most serious effort to

act collectively arose in June 1984, when 11 Latin debtors formed the so-called Cartagena Group<sup>2</sup> at a meeting in Cartagena, Colombia. The group, consisting of foreign and economic ministers, has met several times to try to arrange a political dialogue on debt between Latin American and industrial country governments, and to obtain more dramatic solutions to their debt problems. By late 1984, some of the complaints of the Cartagena had been diffused as dollar-denominated interest rates fell and Latin trade balances showed substantial improvement.

[ ]  
25X1

Since August 1985, however, some Latin leaders including Brazilian Foreign Minister Setubal and Uruguayan Foreign Minister Iglesias have been seeking to strengthen the Cartagena Group because they view it as the best forum to discuss the political aspects of Latin America's foreign debt problem, according to Embassy and press reporting. In recent meetings, the group's attention has centered on preparations for a greater dialogue with the European Community, which has shown a willingness to listen to their concerns. The Cartagena Group has also begun to examine proposals for interest payment relief and have come out strongly advocating increased funding for the multilateral institutions, particularly the World Bank and the Inter-American Development Bank.

[ ]  
25X1

<sup>2</sup>The Cartagena Group consists of Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay, and Venezuela.

[ ]  
25X1

Other Calls for Action

Numerous individual proposals also have been made:

- o President Garcia's move to link debt-service payments to exports and to restructure Peru's bank debt without seeking IMF support has not gone unnoticed by other Latin debtors according to Embassy and press reporting. Some financial observers believe this approach could foreshadow similar actions by additional debt-troubled LDCs. However, many other observers state that Peru could follow the Argentine experience; Argentina attempted to skirt the IMF during most of 1984 but, due to pressure from creditors, was forced to negotiate a new IMF arrangement in August 1985. Nevertheless, Garcia's statements put other Latin leaders in the difficult position of explaining to their constituents why they have taken the more orthodox route.
- o Fidel Castro is attempting to exploit the debt issue, giving numerous speeches and interviews. He has urged Latin Americans to stage "a general strike of debtors" to demonstrate their firmness, according to Embassy and press reporting. Castro's crusade for Latin American debt relief has also included a series of conferences sponsored by Havana that are designed to gain broad-based support for the issue and antagonize US relations with the region. These conferences have generated extensive diplomatic and media attention.

- o Colombian President Belisario Betancur and most Latin leaders reject Fidel Castro's idea of a debt moratorium as unworkable and outside the system of international cooperation, according to Embassy and press reporting. Betancur, however, supports a call for an OECD-financed "Marshall Plan" for Latin America, and has offered two other methods of relieving Latin debt burdens. One idea calls for each industrial country to transfer 1 percent of its GNP annually as soft credits to LDCs. The second proposal is a 5-percent tax on OECD military expenditures to finance lower interest rates for loans to LDCs.
- o Mexican Finance Secretary Jesus Silva Herzog has stated that an equilibrium must be found between the amount of debt servicing paid to commercial banks and the debtor's economic growth, according to press reporting. We believe this tradeoff is the driving force behind the growing Latin sentiment for some kind of interest payment relief. One scheme recommended by several financial experts would capitalize the portion of the interest payment that reflects US inflation, paying only the real interest rate. This would provide debt-troubled countries with more funds to stimulate economic growth. [redacted]

25X1

#### Outlook

We believe the key to overcoming LDC financial problems remains a cooperative effort among the LDCs, commercial banks,

their regulators and governments, and the multilateral financial institutions. Even so, the resolution of these problems presupposes a number of favorable world economic conditions:

- o Sustained OECD economic growth of at least 3 percent during the next several years.
- o Steady or falling dollar interest rates.
- o Open markets in major industrial economies.
- o A gradual fall in the value of the dollar against European currencies and the yen.
- o An increase in the availability of medium- and long-term foreign credit.
- o Slight or only moderate changes in oil prices. [redacted]

- 25X1

During the next 15 months, however, we expect a much less favorable external environment. OECD growth will probably not average the desired 3-percent rate. This slower growth will reduce demand for LDC exports and probably will fuel increased OECD protectionism. At the same time, many observers expect interest rates to trend upward, and oil prices could well fall substantially--hurting oil exporting countries like Mexico, Venezuela, and Indonesia. [redacted]

25X1

The continued pressure on LDCs' trade balances will exacerbate their need for external financing. We believe that despite a reluctance to do so, the financial community will have to address these needs and continue forced lending. Mexico, for example, is likely to need at least \$3 billion in new loans within the next six months. In our judgment, the precarious balance between debtors' adjustment measures and creditors'

continued assistance must be maintained if the LDC financial situation is to improve. [redacted]

25X1

Needed LDC Action

We believe that LDC financial adjustment measures such as devaluations and cuts in subsidies and wages must be complemented by fundamental structural reforms. To restore creditworthiness, bankers say that debtors must strengthen the private sector, [redacted] reduce government involvement in business and industry, increase incentives for private and foreign investment, and adopt export-oriented policies. In our view, efforts in this direction will also reduce rigidities of debtor economies, restore healthy domestic economic growth, and improve foreign exchange positions. Furthermore, these actions would make the domestic financial environment more attractive, slow the rate of capital flight, and could lead to the actual repatriation of capital.

BOX 1

BOX 2

25X1

Financial Community Response

The adjustment efforts of the LDCs will require the support of commercial banks, multilateral organizations, and industrial donor governments. We believe the challenge currently facing the international financial community is to find a "carrot" that can be used to entice LDCs to make structural changes in their economies. At present, the adjustments made are of a short-term nature, while the fundamental inefficiencies and rigidities of the debtor's economy go unaddressed. Commercial banks, creditor governments, and the multilateral institutions agree that LDCs will not be inclined to undertake politically sensitive

sector reform--just one of the structural changes encouraged by the international financial community--illustrates the difficulties LDC governments face in implementing such structural adjustments. [redacted]

25X1

Box 1

### **The Politics of Structural Adjustment:**

#### **The Case of Public-Sector Reform**

The rapid growth of state-owned enterprises during the 1970s and early 1980s was supported by large-scale external borrowings. As a result of the debt crisis, many LDCs--including Mexico, Brazil, and the Philippines--are now being urged to reduce their involvement in inefficient public enterprises and contain public-sector spending. Creditors believe that the current level of public sector borrowing has crowded out investment in the private sector; they are urging a reallocation of savings to strengthen private enterprise. [redacted]

25X1

LDC government leaders have shied away from state enterprise reform, however, because of the high potential for political fallout. Such reforms can severely interfere with the vested interests of key political supporters. For example, in the Philippines, the brunt of reform in the coconut and sugar monopolies would fall heavily on two of Marcos's key political associates, who provide support for his administration. Fear of unrest arising from public sector unemployment also can inhibit reform. [redacted]

25X1

The political sensitivity of domestic structural changes has resulted in only superficial reform efforts by many LDCs, causing them to fall out of compliance with their IMF-supported adjustment programs. This is a particular problem in democratic countries, where newly elected leaders or those facing upcoming elections are reluctant to alienate key constituencies. Public-

[redacted] 25X1

Box2

### Capital Flight: A Serious Drain

Large-scale capital flight has contributed significantly to LDC financial troubles, exacerbating the debtors' financing needs and forcing them to borrow simply to balance their international accounts. [redacted]

one-third to one-half of

the funds loaned to the LDCs between 1978 and 1983 flowed back out in the form of capital flight. These outflows drained official reserves and denied the countries productive use of their foreign borrowings. [redacted]

25X1

25X1

Capital flight is usually associated with several factors:

- o Overvalued exchange rates make foreign assets more attractive and spark domestic fears of devaluation.
- o Repressive financial policies hold interest rates at negative levels during periods of high inflation and, as a result, cause domestic assets to lose their value.
- o Political and economic instability leads individuals to seek a safehaven for their assets.
- o Corruption in government circles funnels money out of the country. [redacted]

25X1

Under IMF-supported programs, many countries have devalued their currencies and raised interest rates in an attempt to make their domestic markets more attractive and to stem capital outflows. Capital flight peaked in 1982, falling off dramatically in 1983 and 1984; however, it is on the rise again. In Mexico, capital flight during the first half of 1985 is already double the total for 1984, [redacted]

25X1

25X1

[redacted] If capital flight continues to increase and as reserves  
are drained, the financing needs of the LDCs will undoubtedly  
exceed projected levels. [redacted]

25X1

25X1

[redacted]

[redacted]

[redacted]

[redacted]

25X1

[redacted]

structural changes until such actions are tied to financial assistance. [redacted]

25X1

Voluntary lending by commercial banks to most debt-troubled countries--including Brazil, Mexico, Argentina, and the Philippines--is unlikely to occur in this decade. Only a few Latin American countries, those in better financial shape like Venezuela and Colombia, could perhaps receive new voluntary loans from banks within the next two years. In general, banks are trying to contain their concentrations of LDC risk and to lower their LDC exposure relative to capital, according to financial reporting, and a resumption of voluntary lending is not expected until overall LDC debt levels are reduced. Even when that occurs, lending to LDCs will be less of a priority to banks. US banks, for example, will be focusing on new opportunities in interstate banking and investment banking, according to one financial observer. [redacted]

25X1

The lack of commercial bank lending to LDCs has led some US officials and commercial bank officers to suggest that the World Bank's role be enhanced to help boost growth in financially troubled countries. While continuing their efforts in project financing, World Bank officials are just beginning to develop a more catalytic role for the Bank through new and expanded programs, such as cofinancing with commercial banks, aid coordination, collaboration with export credit agencies, and the encouragement of direct private investment. The World Bank is also developing a special fund to provide economic assistance in

Sub-Saharan Africa. These initiatives, however, remain somewhat constrained by the Bank's limited resource base. [redacted]

25X1

While the World Bank attempts to increase its medium- and long-term assistance to LDCs, the IMF remains the focal point for short-term financial assistance. During the next few years, however, we believe the Fund will resist expansion of its scope of responsibility through enhanced surveillance programs, which creditor governments and commercial banks have encouraged, because it does not want to be viewed as the "policeman" of the international financial community. Although the Fund will continue to monitor and assess its members' economies, Fund officials fear that their reports will be viewed as "on/off" indicators of financing. [redacted]

25X1

The Fund's role in assisting debt-troubled countries is likely to diminish because of the current schedule of debtor repayments due to the Fund. According to OECD estimates, the Fund has a record amount of financial assistance currently outstanding that is due to be repaid over the next two to three years. Scheduled repayments will climb from \$3.4 billion this year to a peak of about \$8 billion annually during 1987-89. The two largest IMF debtors--Brazil and Mexico--are due to start repaying their current loans in 1986. Consequently, the IMF could well become a net recipient rather than a net provider of funds unless repayments are rescheduled--a move the Fund strongly opposes for prudential reasons, [redacted]

25X1

25X1

LDC Political Initiatives

The financial problems that are being experienced by many LDCs are becoming a unifying concern for Third World leaders. In our judgment, these leaders will use every available forum to push for financial relief by demanding that industrial countries:

- o Implement sound economic policies to promote world growth and lower real interest rates.
- o Resist protectionist tendencies and thereby provide open markets for LDC exports.
- o Boost multilateral development resources, particularly from the World Bank and Inter-American Development Bank, to increase development lending.
- o Reform some European regulatory environments, which currently restrict commercial bank lending to LDCs.

25X1

Their requests could come to a head this fall. For the first time, the LDCs have submitted proposed reforms of the international monetary system for consideration at the upcoming IMF/World Bank annual meetings in Seoul. These include coordinating industrial countries' exchange rate policies, easing conditionality of international lending, and increasing international liquidity with an additional SDR allocation. Moreover, the economic and foreign ministers of the Cartagena Group also plan to meet in October, according to press reporting. Given the current environment, we cannot rule out more radical demands or actions by debt-troubled countries. In this regard, the Mexican Government bears the closest watching;

its IMF-supported program has been suspended and economic and political pressures, which will intensify if oil prices continue to fall, could lead that country to be first of the big three debtors--Brazil, Mexico, and Argentina--to confront creditors with alternate solutions to the LDC debt problem.

25X1